


The Financial

Meltdown

of 2008—

How Did We Get Here?



The year 2008 is drawing to a close in the midst of arguably the worst American financial crisis since the 1929 stock market crash. The entire face of the American financial system is being radically transformed. The federal government is moving deeper into areas where it is the financier of last resort. As a result, much of the nation's financial mechanics are, by default, being nationalized. And it's not just happening in America. Global financial markets are also being shaken to their core. The great

financial panic that unveiled in 2007, blossomed in 2008, and surely will fester into 2009, is both historic and epic in nature. It is the dominant economic story of 2008, and will continue to be the main feature in 2009. Therefore, it is prudent to take time to try and understand what is happening and what caused it.

In hindsight, there is a series of misdeeds that can be traced throughout the path leading up to the current crisis, and there is plenty of blame to go around. The entire financial system in one form or another made contributions to this entire process. But the system was fine for decades. It worked well with minimal problems. So if the whole system is to blame, the key question then is what changed the system?

I believe the action that initiated the crisis was the re-engineering of mortgage giants Fannie Mae and Freddie Mac during the 1990s from government-sanctioned entities that were discerning about what type of mortgages they pur-





A Note to Our Readers:

chased, into what, in hindsight, may now be viewed as ill-fated mortgage purchasers. In Freddie and Fannie's defense, this does appear to be an action that was largely forced upon them by other branches of the federal government.

There are those who may disagree with this assessment. After all, it is a deep-rooted and multi-branched problem. But I am trying to find the seed. In order to develop my view, allow me a running start.

Prior to the Great Depression of the 1930s, there was a two-tiered financial system in the United States. There were lenders (banks), and borrowers (businesses and individuals). But for reasons that could encompass a history lesson, this structure broke down in the 1930s. Out of its wreckage came a three-tiered system—lender, borrower, and government. The federal government emerged as the guardian and securer of both the lending and the borrowing community. In the realm of the home-mortgage industry, Fannie Mae was born as a private but later government-sanctioned entity that would purchase mortgage loans from banks. The goal was to relieve banks of these non-liquid housing assets and free up the banking system to extend more loans. In the late

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The causes of the current financial crisis

are complex and controversial. Mr. Knold has presented his opinion in the article which does not represent an official position by the Department of Workforce Services. Many experts have and are studying this subject and have published their opinion, theories, and explanations. Here are links to some of those articles:

<http://ssrn.com/abstract=1112467>

<http://www.dallasfed.org/research/eclett/2007/el0711.html>

<http://www.dallasfed.org/research/eclett/2008/el0804.html>

www.cba.ua.edu/~ghoover/Subprime-Mortgage-Products.pdf

<http://articles.moneycentral.msn.com/Investing/Extra/SubprimeMythsWhatWashingtonGetsWrong.aspx>

http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=348885&story_id=12415730

<http://economistsview.typepad.com/economistsview/2008/10/barry-ritholtz.html>

60s, Freddie Mac came along as another government-sanctioned program to augment the market (Freddie started the securitization process).

Fannie and Freddie set strict standards in terms of the types of mortgage loans they would buy (called conventional loans). They looked for healthy credit (or “prime”) borrowers, and would only cover homes up to a certain dollar amount—an amount that largely paralleled middle-class income home purchases. This process seemed to work for many decades until a cry went forth that their lending criteria discriminated against low-income households, many of whom were minorities. Throughout the 1990s, Congress, the Federal Reserve, and the Clinton Administration all put pressure upon Fannie and Freddie to rework their lending criteria, with the intention of

allowing more Americans to experience the homeownership dream. With that, an action that originated from a benevolent motivation, I feel, unintentionally blossomed into our current situation. Fannie and Freddie were now “encouraged” to buy mortgages extended to borrowers with less-than-stellar credit ratings—“subprime” borrowers.

In the late 1970s, a shadow mortgage-purchasing industry began to emerge. Banks didn’t have to sell mortgages to Fannie and Freddie only. They could also sell to any others who so desired to purchase, and these loans began being purchased by investment banks and other “Wall Street” types. Regular loans, subprime loans, rich-people loans, all types of loans were now being bought, packaged, and resold (called securitization) by these “other” mortgage players. Although these new players were largely outside the realm of government regulation, the lending stan-

dards of Fannie and Freddie were the industry’s guiding light. Subprime loans were viewed with much trepidation. When subprime loans were extended by lenders, they usually involved higher mortgage interest rates—with the possibility that the rates would drop lower after a borrower showed several years of making their mortgage payments—and lenders made other moves to minimize or “cover” their risk. This system also worked well until Fannie and Freddie lowered the industry standard.

The whole picture is somewhat analogous to a child’s desire for candy. Left unregulated, children (the profit-



driven mortgage/banking system) will be tempted to dip their hand aggressively into the candy jar. But if Aunt Fannie and Uncle Freddie are diligent overseers by setting the example against the dangers of candy's excess, then the children will, by example, be tempered. But what happens when Aunt Fannie and Uncle Freddie start dipping their hands into the candy jar? What will the children do?

Government pressures in various forms throughout the 1990s moved Fannie Mae and Freddie Mac to embrace the purchasing of subprime loans. With the industry standard bearers now not only condoning previously shunned lending vehicles, but also purchasing them in large quantities, the stage is now set for the additional transgressions that followed. If the federal government is now in the business of buying out and backing risky loans, naturally one can see

how the rest of the industry then let down its guard and indiscriminately promoted these types of loans. After all, the sellers of these loans weren't going to be the end buyers of the loans. What did the middleman have to lose if the government was willing to buy?

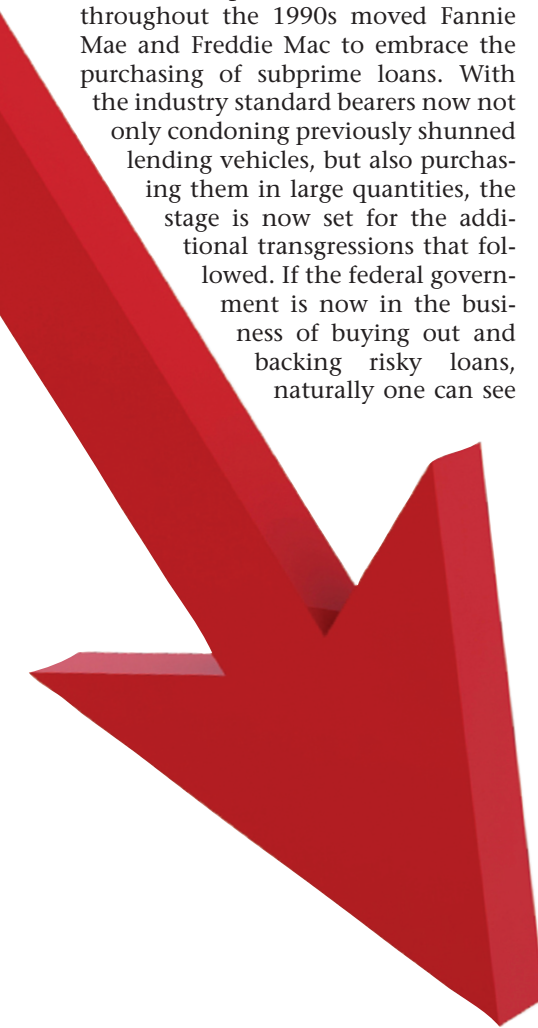
Would the excessive promotion and use of subprime mortgages have blossomed without Fannie and Freddie embracing them first? Would the virtual ignoring of covering the risks inherent in subprime lending—a result we saw in the 2000s—arise if Fannie and Freddie hadn't condoned subprime activities? Would housing prices have spiraled so high without excessive subprime use? I make the argument that these and other corollaries would not. After all, there is a 20-year history of no subprime excessiveness prior to Fannie and Freddie's re-engineering.

And so we have the current economic consequences. As is sometimes the case with government actions upon the economy, the originators of an action are long removed and the current management has to not only try and rectify the situation, but also is saddled with the blame. Problems of this magnitude usually have long and deep roots.

With the criterion now changed, between 2004 and 2007, Fannie Mae and Freddie Mac bought roughly \$1 trillion in subprime and Alt-A mortgages. The two combined to be the nation's largest buyers of subprime mortgages. They carried \$5 trillion worth of home mortgages, of which one in five was subprime.

When the first rate resetting of subprime mortgages struck en masse in 2007 and 2008—preceded by a collapse in U.S. housing prices—Fannie Mae and Freddie Mac's asset base dissolved. The United States government stepped in to take over, and stockholders lost all. Twenty percent of U.S. banks held Fannie Mae and Freddie Mac stock.

Unintended consequences are the bane of any action, even ones generated from a benevolent motivation. Unintended consequences are unfolding before us, and the end result is a strong possibility that the American financial system, as we know it, may undergo radical change. Globalization will have a big say in the new structure. It will be a system built upon regulation and unification. Regulation in and of itself is not the answer. Smart regulation is. ⓘ



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